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Directorate of
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Yugoslavia's Financial Crisis

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An Intelligence Assessment

State Dept. review completed

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EUR 82-10126
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Yugoslavia's Financial Crisis [redacted] 25X1

An Intelligence Assessment

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This assessment was prepared by [redacted] 25X1
[redacted] of the East European Division, Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, East European Division, EURA, [redacted] 25X1 25X1

This paper has been coordinated with the National Intelligence Council. [redacted] 25X1

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Yugoslavia's Financial Crisis [redacted]

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Summary

Information available as of 19 November 1982 was used in this report.

Yugoslavia is fast approaching insolvency after trying unsuccessfully this year to secure new Western credits and to roll over all short-term credit lines. Its credit problems—combined with a higher current account deficit than projected—have forced Belgrade to draw down reserves and augment austerity measures in an attempt to cover this year's financing requirement. By the end of the year, official foreign exchange reserves could fall to $500-600 million, the equivalent of only three weeks' worth of hard currency imports. [redacted]

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In a financially weak and vulnerable position, Yugoslavia faces heavy debt service obligations and a seasonally low inflow of foreign exchange receipts in the first half of 1983. The resulting financial gap will probably exceed Belgrade's remaining official assets and the cash it can obtain from domestic commercial banks. Our analysis of three borrowing scenarios for 1983 concludes that only substantial emergency support from Western governments and central banks or multilateral debt rescheduling would permit Belgrade to avoid large arrearages and eventual default. [redacted]

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Belgrade's recent actions to conserve hard currency and boost exports may have some salutary effect on the balance of payments, but so far they do not seem to have revived sufficient lender confidence to prevent a payments crisis early next year. The imposition of the new austerity program suggests that Yugoslav leaders are willing to pay a high price to avoid debt rescheduling—a step that would allow some breathing space for adjustment but that, in their eyes, would damage national prestige. [redacted]

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There is good reason to believe that the political repercussions of a financial crisis necessitating rescheduling could be severe, and perhaps pose the crippling blow for the post-Tito leadership. Key federal institutions—the Communist Party and the state bureaucracy—are already being blamed by the public for the difficulty and are under pressure to launch economic reforms which, in turn, could lead to increased agitation for political reforms. The divergence of interests among the republics and already serious ethnic rivalries could worsen rapidly if Belgrade fails to convince the public that it can cope with the crisis. [redacted]

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Yugoslavia's Financial Crisis

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Payment Difficulties Appear

Yugoslavia's financial position deteriorated noticeably in fourth-quarter 1981. The general cutback in Western credits to Eastern Europe and Western bankers' criticism of Belgrade's economic management prevented the Yugoslavs from raising a $400 million syndicated loan from US, British, Canadian, and Japanese banks. The Yugoslavs then had to resort to more expensive short-term borrowing to cover their 1981 financing needs.

Early this year Yugoslavia's financial image was further tarnished when several regional banks were forced to ask Western creditors for extensions on debt repayments and for rollovers of short-term loans. The regional banks, particularly Privredna Banka Zagreb (PBZ), were suffering serious shortages of hard currency, partly because the large short-term borrowings made in late 1981 were coming due. Federal Executive Council (FEC) member Janko Smole reported to the National Assembly in July that the National Bank and several of the stronger regional banks had to provide nearly $500 million to cover arrearages and other payments for the weaker banks. Despite these outlays, some payment extensions and rollovers for regional banks, and a new law to improve cash management in the banking system, Western creditors have continued to report to US officials and the press missed payments by Yugoslav banks.

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These borrowing problems have put severe pressure on Yugoslavia's reserve position. Total reserves fell by $910 million in the first half of 1982, and the IMF now expects that they will drop another $340 million by the end of the year. According to a public statement by the Yugoslav Deputy Premier, Yugoslavia faces heavy debt service payments in December. Almost $1 billion of the reserve drawdown is expected to come out of the National Bank's foreign exchange holdings. This would leave official reserves at $500-600 million—equivalent to three weeks' worth of imports. While the domestic business banks as a group still hold a reasonably large pool of funds, many individual banks face sizable short-term liabilities. So far Belgrade's efforts to move funds from stronger regional banks to cash-short institutions have proved inadequate; moreover, the foreign assets of many commercial banks probably cannot be drawn down further since they represent, in large part, working and compensating balances.

Belgrade's Actions To Deal With the Crisis

While scrambling to arrange new credits, Belgrade has responded to the financial squeeze by implementing new foreign exchange controls and imposing austerity measures. In May 1982 a regulation was adopted to help make foreign exchange available where it was needed most. It required that:

- Republics and provinces project their 1982 balance-of-payments and foreign exchange needs by quarter and coordinate balance-of-payments targets.
- The FEC and republic authorities agree on the amount of foreign credit to be obtained for imported equipment and raw materials in 1982.
- No other new foreign debts be incurred except for short-term credits to meet seasonal foreign exchange shortages, and that these be approved by the FEC on an individual basis.
- Export earnings be repatriated to Yugoslavia within 60 days instead of the previous 90 days.
- Banks and enterprises turn over a stipulated amount of their hard currency revenues to the National Bank. 25X1

This law failed to produce a major improvement in Yugoslavia's payments record due, in part, to the National Bank's difficulty in getting the regional banks to comply. In fact, arrearages by a key Zagreb bank have been a sticking point in the negotiations this fall for the $200 million US-Japanese syndication. 25X1

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By October it was clear that the Yugoslavs were running out of reserves and would miss their current account target. The FEC responded with a package of measures designed to promote exports, slow the outflow of foreign exchange, and provide inducements to increase the flow of hard currency into the banking system. The measures provided:

- New foreign exchange credits for raw material imports for export industries. 25X1
- Disincentives to foreign travel—for example, mandatory dinar deposits prior to each trip abroad.
- An end to duty-free imports and to full payment of Yugoslav diplomats' salaries in hard currencies.
- Limitations on imports by private citizens to about $24 a year.
- Fines ranging from $100 to $400 for the use of foreign exchange in domestic transactions.
- Informal restrictions on withdrawals of foreign exchange deposits to $250 a month.

On 22 October Belgrade strengthened the stabilization program by devaluing the dinar 20 percent. This step was needed because the gradual depreciation of the dinar during 1982 only offset the relative rise in

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Yugoslav prices and did little to lower export prices. Nonetheless, Yugoslavia will not gain a competitive edge in Western markets unless authorities can keep a lid on wages and prices and are willing to permit further devaluations.

Although the Yugoslav program may lead to some short-term improvement in the balance of payments—just as restrictions on imports did—we believe that it will not solve Yugoslavia's financial problems. Some measures indeed could backfire since restrictions on the use of foreign exchange, for example, are likely to discourage the inflow of worker remittances. Getting to the root of the financial problem would require fundamental policy changes aimed at restraining domestic demand, improving productivity, and controlling inflation.

The actions taken in October apparently have done little to bolster lagging banker confidence in Yugoslavia. We believe that, even if Belgrade decides to implement systemic reforms, commercial banks may well hold back on major new lending until an international rescue effort is mounted for Belgrade. As systemic measures are unlikely to produce good results in the short run, Yugoslavia probably will be unable to restore banker confidence soon without outside help.

While Belgrade's efforts to cope with balance-of-payments difficulties have not successfully curbed domestic demand this year, they nevertheless have had a serious impact on growth. Industrial production has ground to a standstill, rising only 0.7 percent in the first eight months of 1982, and consumers are complaining about an erosion in living standards. Several sources report there is fear on the part of some leaders (especially in Croatia) that more import cuts and diversion of domestic supplies to exports could lead to serious disruptions in economic activity.

Nonetheless, Yugoslavia's rapidly deteriorating financial outlook has prompted the leadership to press ahead with new austerity plans and reform proposals for next year. Deputy Premier Dragan announced to the Federal Assembly on 10 November plans for wide-ranging reform of the banking system. Dragan did not provide details on these plans but some of the provisions reportedly place greater responsibility on individual republics, banks, and enterprises for managing their own debts. Arguing that foreign credits will be radically reduced in 1983, the Deputy Premier called for 15- to 20-percent growth in exports and 13-percent reduction in imports. To restrain domestic demand, Dragan said Belgrade plans to cut personal consumption by 6 to 7 percent, federal spending by 10 to 12 percent and investment by 20 percent. He warned that failure to adopt the proposed policies will force a debt rescheduling.

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Bleak Prospects for 1983

Even if Yugoslavia remains solvent through the end of this year, it almost certainly will need debt relief or emergency aid from Western governments or central banks in the first half of 1983. Without a major reversal in bankers' attitudes, likely sources of credit will fall far short of Yugoslavia's needs to cover its current account deficit and debt repayments. The alternative to Western government support or debt rescheduling would require exhausting official reserves and slashing imports in order to avert default. Even a short-term loan from the BIS would not help Yugoslavia's financial position substantially unless the credit was linked to a package of credits with longer repayment terms. We believe that medium-term Western assistance or rescheduling of most debt service payments are the only means by which Yugoslavia could rebuild its reserves and obtain breathing space to implement the adjustment measures to reduce its payments deficit. Belgrade's success in finding a solution to its financial problems depends ultimately, however, on the strength of its political will to implement systemic reforms and essential, but unpopular, stabilization measures.

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Financial Requirement
For 1983 as a whole Yugoslavia faces a financing requirement of $4.7 billion, down from $6.7 billion in 1981 and $5.5 billion this year. Since seasonal factors push Yugoslavia's current account deeply into deficit in January-June, Belgrade will be looking for $3.8 billion to cover its current account and debt repayments in the first half of the year. A projected surplus on current account and a decline in short-term debt repayments in the second half of 1983 should reduce financing needs to $970 million in July-December.

Current Account. We estimate that Yugoslavia's current account deficit will total nearly $1.3 billion in the first six months of 1983, compared with $1.5 billion in the same period of this year. A surplus in July-December should reduce the deficit for the year as a whole to under $300 million. Our estimate is based on the premise that Belgrade will continue to implement an effective stabilization program while allowing a sufficient inflow of imports to keep output growth from slowing further and export performance from being hurt. We assume that the IMF will insist that Belgrade take effective steps to restrain the growth of domestic demand and the rise of wages and prices, while permitting further depreciation of the dinar.

With these assumptions we project that hard currency exports will rise by about 5 percent in 1983 (a 5.6-percent annual rate in the first half of the year combined with a 4.8-percent rate in the second half), compared with 2.2 percent in 1982. We expect this improvement in export performance to result from:
- The 20-percent devaluation of the dinar on 22 October and further devaluations to offset domestic inflation.
- Priority allocation of foreign exchange for imported raw materials used in production of exports.
- Priority access to domestic resources for export industries.
- No slowdown of growth in Yugoslavia's Western markets.

We do not believe, however, that growth of domestic industrial production or of Western markets will be strong enough to permit Yugoslavia to attain its ambitious target of a 15- to 20-percent increase in hard currency exports.

We also project that the Yugoslavs will be able to cut imports by only 5 percent instead of the planned 13 percent. Most of the improvement in the current account in recent years has been the result of reduced imports: hard currency imports were held constant in 1980 and fell by 6 percent in 1981 and 15 percent in 1982. This year's cuts helped to bring industrial production to a standstill, and we do not believe that the Yugoslavs can continue to reduce imports at the current rate without seriously damaging industrial output and export performance and aggravating consumer supply problems. 25X1

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Following the pattern of last year, we expect imports to be some $500 million higher in the first half of the year than in the second, given the need to import energy and agricultural products during the winter months. Lack of data on stocks of imported goods limits our ability to forecast requirements, but after three years of import austerity, inventories have probably been drawn down. 25X1

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After a rise in tourist earnings of only 5.5 percent in 1982, we forecast a rise next year of 13 percent, partly as a result of the October devaluation. While tourism could be deterred by reports of Yugoslavia's economic difficulties, Belgrade is trying to minimize this danger with special provisions to reduce the impact of shortages on foreign tourists. Receipts from tourism are highly seasonal, with three-fourths of the total coming in the second half of the year.

We expect that the unofficial limits on hard currency deposit withdrawals and growing unease about Yugoslav financial problems will lead to a sharp reduction in worker remittances in 1983, to $3.5 billion from $4.3 billion in 1982. Remittances also follow a seasonal pattern, with roughly 60 percent arriving in the second half of the year. On the other hand, we expect that informal restrictions on foreign exchange deposit withdrawals will cause outflows to decline in 1983.

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Debt Repayment Schedule. Repayments on Yugoslavia's medium- and long-term debt including a small amount of payments due to the IMF are projected at $2.4 billion for 1983, with approximately $1.2 billion falling due in each half of the year. The IMF estimates that short-term debt repayments will total $1.2 billion in the first six months of 1983 and $600 million in the last half of the year.

Financing Scenarios for 1983

We have considered three borrowing scenarios in the attempt to judge Yugoslavia's ability to cover its 1983 financing requirement:

- The Yugoslavs rely entirely on financing from suppliers, private banks, the IMF, and the World Bank; they receive no BIS support nor any debt relief from creditors.

- In addition to the financing obtained under scenario 1, the Yugoslavs receive a short-term $750 million BIS credit in the first half of 1983 that must be repaid by yearend.

- In addition to the credits obtained in scenario 2, the Yugoslavs reschedule 90 percent of maturing medium- and long-term loans from both private and official creditors and 90 percent of interest on official debt. These rescheduling terms are broadly similar to those obtained by Poland in 1981.

We have made the following assumptions regarding financing provided by suppliers, private banks, the IMF, and the World Bank in 1983:

- Western banks do not provide any new medium-term financial credits. At this time Western banks seem unlikely to raise any major new loans for Yugoslavia, but early next year Belgrade may succeed in obtaining $200-300 million from Kuwaiti banks.

- The Yugoslavs roll over $900 million of the $1.2 billion short-term debt coming due in the first half of 1983 and $400 million of the $600 million maturing in the last half of the year. This projection reflects the IMF forecast of a $500 million net decline in short-term debt in 1983. Unease among Western lenders about Yugoslavia's creditworthiness could lead to a more rapid withdrawal of short-term deposits placed with Yugoslav banks and termination of short-term credit lines. 25X1

- Suppliers continue to extend medium-term credits at the rate of approximately 10 percent of imports.

- The Yugoslavs remain eligible for the last tranche of the IMF standby; committed IMF and World Bank credits are assumed to equal $400 million in each half of the year. 25X1

Scenario 1. Under scenario 1 Yugoslavia would suffer a financing gap during the first half of 1983 that would far exceed its official foreign exchange reserves and the cash that it probably could mobilize from domestic commercial banks. (The Yugoslavs could sell from their gold stock but more likely would pledge this as collateral for the BIS loan discussed in scenario 2.) Even if Belgrade could narrow the gap with a $200-300 million medium-term loan from Kuwait or other sources and draw down reserves by $500 million, it would have to cut imports by more than 25 percent from the $4.6 billion we project to eliminate 25X1 the financing gap. This would likely put severe strains on industry and disrupt export performance, thus undermining efforts to achieve payments equilibrium. 25X1 Even if these drastic measures enabled Yugoslavia to remain solvent through the first half of the year, the small financing surplus projected for the last half would permit only a slight rebuilding of reserves. The Yugoslavs would then be in an even weaker position entering the first months of 1984. 25X1

Scenario 2. Extension of a BIS loan would reduce the first half-year financing gap but probably would not improve Yugoslavia's financial position over the year as a whole. Belgrade possibly could cover the $1.3 billion projected gap for the first half of the year

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Table 2
Yugoslavia: 1983 Financing Scenarios

Million US $

	Scenario 1 IMF Projection of Financing (No BIS Loan or Rescheduling)			Scenario 2 $750 Million BIS Loan			Scenario 3 Western Government and Bank Rescheduling Plus BIS Loan		
	1983 Full Year	1983 First Half	1983 Second Half	1983 Full Year	1983 First Half	1983 Second Half	1983 Full Year	1983 First Half	1983 Second Half
Financing requirement	**−4,745**	**−3,775**	**−970**	**−5,495**	**−3,775**	**−1,720 [a]**	**−5,495**	**−3,775**	**−1,720 [a]**
Borrowing sources	**3,000**	**1,750**	**1,250**	**3,750**	**2,500**	**1,250**	**6,135**	**3,535**	**2,600**
Medium-term credits	1,700	850	850	1,700	850	850	1,700	850	850
IMF/IBRD	850	400	450	850	400	450	850	400	450
Supplier credits [b]	850	450	400	850	450	400	850	450	400
Short-term credits [c]	1,300	900	400	1,300	900	400	1,300	900	400
BIS loan	NA	NA	NA	750	750	0	750	750	0
Rescheduling [d]	NA	NA	NA	NA	NA	NA	2,385	1,035	1,350
Financing gap	**−1,745**	**−2,025**	**280**	**−1,745**	**−1,275**	**−470**	**640**	**−240**	**880**

[a] In scenarios 2 and 3, repayment of the $750 million BIS credit drawn in the first half of 1983 is added to the financing requirement for the second half of the year.
[b] Supplier credits are estimated to be approximately 10 percent of imports.
[c] Short-term credit drawings are shown in accordance with IMF projection.
[d] Assumes 90-percent rescheduling of principal payments due on medium- and long-term debt to both official and private creditors plus 90-percent rescheduling of interest due official creditors (estimated to equal $300 million).

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through reserve drawdowns, import cuts, and a possible $200-300 million Kuwaiti loan. However, if the BIS credit were not linked to a medium-term financing package and if the Yugoslavs had to repay the $750 million by yearend, they would have to make further reserve drawdowns and import cuts in the latter part of the year. The net impact would be only marginally different from that of scenario 1 unless central bank help promoted substantially more lending by Western commercial banks. The banks, however, would likely remain wary about new lending to Yugoslavia if their credits were in effect merely paying off the BIS.

Scenario 3. Rescheduling 90 percent of principal repayments due in 1983 and 90 percent of interest on official debt (in addition to receiving the new loans included under scenarios 1 and 2) would eliminate the financing gap for next year and enable Yugoslavia to rebuild about half of the reserves drawn down this year. Belgrade would have some breathing space to take measures to reduce the balance-of-payments deficit. Such Yugoslav actions, of course, would be required for a BIS credit/debt rescheduling package. If Yugoslavia rebuilt reserves next year and brought its current account at least into balance by 1984, it might be able to weather the crisis without further rescheduling. With a balanced current account, the 1984 financing requirement would fall to $3.5 billion—$2.3 billion medium- and long-term debt repayments and $1.2 billion short-term repayments.

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The Political Dimension [1]

As Yugoslavia's financial position has continued to deteriorate, the leadership has reiterated its determination not to reschedule. Federal-level officials have repeatedly indicated that they are prepared to take draconian measures to avoid a rescheduling. These leaders behave as if they presume, however, that Yugoslavia will have enough Western financial support to see it through its lean years. In the absence of such help, popular confidence would decline and we believe that there would be a reasonable chance of a political crisis in Belgrade which could undermine national stability and further erode lender confidence. [redacted]

Republic-level officials, however, may not share the federal regime's resolve to avoid a rescheduling. A senior Croatian party official told the US Ambassador in September that the Croatian leadership now believes that a rescheduling is necessary; it fears that more import cuts and diversion of domestic supplies to exports could lead to some sort of economic collapse. Nonetheless, the Croat acknowledged that these arguments have fallen on deaf ears in Belgrade, which he says still regards a debt rescheduling as too humiliating. [redacted]

We believe that at least some federal leaders fear a rescheduling would lead to stronger demands for systemic economic reforms. The Communist Party leadership is deeply divided on the reform issue and has rejected all such proposals. Even moderate efforts since Tito's death to alter the decentralized system by shifting more authority to Belgrade have loosed serious squabbling. And we suspect that the weakened federal regime, now having more difficulty in asserting its authority, will become increasingly more fearful that it could not control the political currents that would flow from major reforms. [redacted]

[redacted]

Although the political risks of rescheduling are substantial, the alternative of a Western bailout assistance package is not a clear-cut panacea. There is no certainty, for example, that the federal authorities would have the ability—much less the will—to impose the political and economic reforms necessary to modify the economic system. The political and economic systems are highly resistant to change, largely because more than 15 years of decentralization have allowed republics and provinces to become nearly autonomous on economic issues. In the absence of a dominant figure such as Tito, the required consensus decisionmaking has proven unimaginative, reactive, and capable of only ad hoc adjustments. In these circumstances, the federal leadership might see the offer of Western aid merely as a way of easing up on its austerity program and of coasting along without having to take politically difficult measures. [redacted]

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Neither rescheduling nor a Western bailout by itself, therefore, can promise an end to Yugoslavia's descent into instability. Clearly, on the other hand, there is little hope for the party hierarchy to arrest the decline in its authority while under the growing pressure of financial problems. [redacted]

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